Monthly Market Review –December 2016

The post Trump surge on stock markets continued in December. Markets are focussing on tax cuts, deregulation and fiscal stimulus; and not on potential negatives for markets from a Trump presidency such as protectionist measures and trade wars.

How the different asset classes have fared *(As at 31st December 2016)*

Asset Class	10 Yr % p.a.	5 Yr % p.a.	3 Yr % p.a.	1 Yr %	YTD %	6 Mo %	3 Mo %	1 Mo %
Cash[1]	4.1	2.8	2.4	2.1	2.1	0.9	0.4	0.1
Australian Bonds[2]	6.2	5.0	5.1	2.9	2.9	-2.0	-2.9	-0.2
International Bonds[3]	7.4	6.1	6.3	5.2	5.2	-1.4	-2.2	0.4
Australian Shares[4]	4.5	11.6	6.8	11.6	11.6	9.9	4.4	4.2
International Shares Unhedged[5]	4.7	18.6	11.5	7.9	7.9	9.8	7.7	4.5
International Shares Hedged[6]	6.5	15.5	9.2	10.6	10.6	10.6	5.3	2.9
Emerging Markets Unhedged[7]	2.7	8.6	4.6	11.7	11.7	7.4	1.3	2.3
Listed Infrastructure Unhedged[8]	N/A	16.7	13.6	11.2	11.2	-0.2	1.6	5.0
Australian Listed Property[9]	0.3	18.5	18.0	13.2	13.2	-2.6	-0.7	6.8
Int. Listed Property Unhedged[10]	N/A	17.5	16.5	5.9	5.9	-2.6	0.2	6.2

[1]Bloomberg AusBond Bank 0+Y TR AUD, [2]Bloomberg AusBond Composite 0+Y TR AUD, [3]JPM GBI Global Ex Australia TR Hdg AUD, [4]S&P/ASX All Ordinaries TR, [5]MSCI World Ex Australia NR AUD, [6]Vanguard Intl Shares Index Hdg AUD TR, [7]MSCI EM NR AUD, [8]S&P Global Infrastructure NR AUD, [9]S&P/ASX 300 AREIT TR, [10]FTSE EPRA/NAREIT Global REITs NR AUD

Cash

The Reserve Bank of Australia (RBA) left the overnight cash rate at 1.5% at its final meeting for 2016. There is no meeting in January, the first for 2017 is on February 7th.

Pricing in the futures market currently implies a 56.5% probability of the RBA remaining on hold right out to July. The market has swung from a 1 in 4 chance of a rate cut by midyear to now a 40% chance of a hike in interest rates.

Bonds

The sharp move in bond yields in November moderated in December, capping losses (bond prices move in the opposite direction to yields, an increase in yields sees bond prices decline and bond investors sustain an (unrealised) capital loss). International bonds managed to claw back a small gain in December

The movement of bond yields over the course of 2016 was quite remarkable.

Yields defied expectations and continued to get even lower in the first half of the year. The Australian 10 year government bond got to a low of 1.8% in early August. It then rocketed up by more than a full percentage point to 2.9% just before Christmas.

Most of this move can be put down to Australian bonds being pulled along by the US market. The US 10 year hit a low of 1.4% in early August and then climbed to a year high of 2.6% in mid-December. Having said this, the spread (that is the extra yield investors demand to hold Australian bonds over US bonds) continued to tighten, as it has been doing for several years now. Three years ago the spread between the Australian and US 10 years was 1.3%. This has now shrunk to 0.28%.

In this way the bond market is recognising the contrasting circumstances of the Australian economy (adjusting to the end of the biggest mining boom) and that of the US (at full employment with the prospect of pro cyclical fiscal stimulus to add fuel to the fire) are in.

Australian Equities

Australian equities jumped by over 4% in December, giving a healthy 11.6% return for 2016. As well as the general revival of Keynesian “animal spirits”, Australian shares were driven by developments in China.

The Chinese authorities, spooked by a sharp slowdown in growth, hit the stimulus lever in late 2015. This saw a revival in both infrastructure and residential property construction in 2016; and a subsequent rally in commodities like Australia’s key export of iron ore.

In addition, an environmentally driven clampdown on domestic coal producers saw the two coals (coking and thermal) rally.

Finally, much of the extreme move in iron ore prices (going from USD39.51 a tonne at the start of 2016 to a high for the year of 83.58 on the 12th of December) cannot be explained by fundamentals. Indeed, iron ore stockpiles in China by the close of the year were back to 2014 levels Supply also continues to come online. Gina Reinhardt's Roy Hill project, Anglo American's Minas Rio and Vale's S11D along with others will see 686 million metric tons added to seaborne iron ore supply in the first half of 2017. To put that in perspective the total seaborne iron ore market was 1,328 million tons in 2014.

The move in iron ore in the latter half of 2016 looks like it was driven by Chinese speculators. With the money supply tightly controlled and financial markets relatively undeveloped, French bank Société Générale's Chinese economist recently described the Chinese economy as working like squeezing a balloon. You press it in one place and it just bulges out elsewhere; when Beijing moves to deflate one bubble this just drives the expansion of another. 2016 saw this playing out across a range of commodities. Towards the end of the year it reached such esoteric ones as financial instruments based on glass (highest in 2 years in late 2016) and garlic (up 80% over a year).

International Shares

Developed market equities continued their push upwards, adding another 4.5% in December. The US dollar continued to strengthen against all currencies including the Australian dollar, resulting in currency hedged international shares only returning 2.9%.

US stocks added just over 4%, European stocks bounded ahead, adding 9.5% over the month. Japanese stocks also gained around 4%.

Emerging markets stocks recovered following the post Trump sell off on fears of protectionism and rising US interest rates. The broad EM complex gained 2.3% (in Australian dollars).

Brazilian shares gave up -3% for the month, but still remained one of the best performing markets globally for the year with 37% in local currency terms and an eye watering 67% in USD.

Chinese stocks dropped 4% as fears that the incoming President would aggressively target Chinese exports to the US. This capped a disappointing 2016 for Chinese shares with just a 1% gain for the 12 months.

Indian sharemarkets lost around 1% as "demonetisation" caused chaos. Around 80% of currency in circulation was declared not legal tender overnight, forcing Indians to queue for hours at banks to exchange their old bank notes for new ones.

The so called "bond proxies" bounced nicely in December. Australian property recovered near to 7% after heavy falls in prior months. International property and infrastructure also saw good gains.

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